28

Tax-Saving Ideas and Planning

Tax planning is a year-round activity. By planning income and deduction strategies, you may be able to reduce your tax. You may defer certain income to a later year in which you expect to pay a lower tax, and accelerate deductions to a higher tax year. Tax-free investments are available and, within limits, income splitting with family members may be possible.

This chapter illustrates basic tax-planning strategies. In subsequent chapters, tax-savings plans for homeowners, families, investors, and executives are discussed.

¶28.1 When To Defer Income and Accelerate Deductions

When you expect to pay less tax in a future year than in a current year, consider deferring income and accelerating deductions. There are two strategies: (1) to postpone receipt of income to a year of lower tax rates, and/or (2) to claim deductions for losses and expenses in the year you are subject to the higher tax rates. In planning to defer income and accelerate deductions, however, watch these tax-rule limitations.

Postponing income. You may not defer salary income by not cashing a paycheck or not taking salary that you have earned and that you can receive without restrictions. Under certain conditions, you may contract with your employer to defer the taxable receipt of current compensation to future years. To defer pay to a future period you must take some risk. You cannot have any control over your deferred pay account. If you are not confident of your employer's ability to pay in the future, you should not defer pay.

If you are self-employed and are on the cash basis, you can defer income by delaying your billing at the end of the year or extending the time of collection. If you own a closely held corporation, you can time the payment of dividends and bonuses.

Accelerating deductions. In accelerating deductions, there are these limitations: You may not deduct prepaid interest and rent. Prepaid interest must be deducted over the period of the loan. Rentals must also be deducted over the rental period. However, you can generally deduct prepayments of state income tax and accelerate your payments of charitable contributions. Annual subscriptions to professional journals and business magazines can be renewed before the end of the year. If the subscription is for more than a year, you may deduct only the first-year prepayment. The cost of the later subscription must be deducted in the later year. Contributions, purchases, and business expenses charged to credit card accounts are deductible in the year of charge, even though you do not pay your charge account bill until the next year. You can also realize losses by selling business or investment property which has lost value in the year you want to incur the loss.

Making an extra donation at the end of the year also may provide an added deduction which may lower your tax. You may deduct a charitable gift made by check on the last day of the year, even if the check is not cashed until the new year begins. Charitable donations may be timed to give you the largest possible tax savings. If, toward the end of the year, you find that you need an extra deduction, you may make a deductible donation in late December. Doing so would be especially beneficial if you know that your tax bracket will be lower the following year; *see* Chapter 14 for further planning details.

Also *see* Chapter 13 for claiming the standard deduction and itemizing deductions in alternate years, and Chapter 23 for planning steps when you may be subject to alternative minimum tax.

Deferring interest income to next year. Buying six-month certificates after June 30 can defer interest reporting to the next year. As a general rule, you have to report interest credited to your savings account for 1996, even if the account is a passbook account and you did not present the passbook to have the amount entered. Similarly, interest coupons due and payable in 1996 are taxable on your 1996 return, regardless of when they were presented for collection. For example, a coupon due in December 1996, but presented for payment in 1997, is taxable in 1996. However, there are opportunities to defer interest in the following ways:

1. Buy a savings certificate after June 30 with a maturity of six months or more. Interest is taxable in the next year when the certificate matures, provided that interest is specifically deferred until the following year by the terms of the certificate.
2. Buy Treasury bills which come due next year. Six-month bills bought after June 30 will mature in the next year. You can make these purchases through your bank or broker.
3. Buy Series EE bonds. These bonds may be cashed for their purchase price, plus an increase in their value over stated periods of time. The increase in redemption value is taxed as interest. You may defer the interest income until the year you cash the bond or the year the bond finally matures, whichever is earlier.

Timing sales of property. A sale is generally taxable in the year title to the property passes to the buyer. Since you can control the year title passes, you can usually defer income realized on the sale to the year in which you will pay less tax. Year-end sales of securities are discussed at ¶30.2.

¶28.2 Tax Cost of Earning Over the Thresholds for the Exemption Phaseout and Itemized Deduction Reduction

In figuring the tax cost of earning additional income, consider the phaseout of personal exemptions (¶22.15) or the 3% reduction to itemized deductions (¶13.8). When extra income, such as from a bonus, a free-lance assignment, or a year-end sale of stock, pushes you over the *threshold* for the exemption phaseout or the 3% reduction, or if you already are over the threshold, the marginal tax rate on the extra income will be higher than the stated maximum rate for ordinary income (31%, 36%, or 39.6%), or 28% for net capital gains. By earning over a threshold amount, your taxable income is increased not only by the earnings over the threshold but also by the amounts disallowed by the phaseout or the 3% reduction.

For the 3% itemized deduction reduction on 1996 returns, the adjusted gross income (AGI) threshold is $117,950, except for married persons filing separately, who are subject to a $58,975 threshold.

For the exemption phaseout, the AGI threshold is $117,950 for single persons, $147,450 for heads of household, $176,950 for married persons filing jointly and qualifying widow(er)s, and $88,475 for married persons filing separately.

Effective rate increase. The amount of the increase in the effective rate due to the exemption phaseout or 3% itemized deduction reduction can be estimated by this equation:

$$\text{Increase in effective rate} = \frac{\text{Top bracket}^{*} \times \text{disallowed amount}}{\text{Excess income over threshold}}$$

*Your top bracket. For example, if you are in the 36% bracket (*see* the tax rate schedules on page 365), take 36% of the disallowed amount.

Key to Tax Planning

Objective—	*Explanation—*
Earning tax-free income	You can earn tax-free income by— 1. Investing in tax-exempt securities. However, before you invest, determine whether the tax-free return will exceed the after-tax return of taxed income; *see* ¶30.18. 2. Taking a position in a company that pays substantial tax-free pay fringe benefits, such as health and life insurance protection. For a complete discussion of tax-free fringe benefits, *see* Chapter 3 . 3. Seeking tax-free benefits offered by scholarship arrangements; *see* ¶12.4. 4. Taking a position overseas to earn up to $70,000 of tax-free pay; *see* Chapter 36.
Deferring income	You can defer income to years when you will pay less tax through— 1. Deferred pay plans, which are discussed in Chapter 32. 2. Qualified retirement plans such as through Keogh plans and IRA investments; *see* Chapter 41 and Chapter 8. 3. The year-end planning techniques explained in ¶28.1. 4. Transacting installment sales when you sell property; *see* ¶5.25. 5. Investing in U.S. Savings EE bonds; *see* ¶4.28 and ¶30.21.
Income splitting	Through income splitting you divide your income among several persons or taxpaying entities that will pay an aggregate tax lower than the tax that you would pay if you reported all of the income. Although the tax law limits income-splitting opportunities, certain business and family income planning can provide tax savings. Family income planning is discussed in Chapter 33.
Tax-free exchanges	You can defer tax on appreciated property by transacting tax-free exchanges as discussed at ¶6.1 and ¶31.4.
Buying a personal residence rather than renting	Homeowners are favored by the tax law. 1. Rather than paying rent, buy a home, condominium, or cooperative apartment. You may deduct interest and taxes. When you sell your house, you may defer tax on the gain (but a loss on a personal residence is not deductible). And, if you are age 55 or over, you also may take advantage of a one-time $125,000 exclusion; *see* Chapter 29. 2. Homeowners can borrow on their home equity and deduct interest expenses; *see* ¶15.3.